Hanging

Saudi Arabia is a paradox, an insular, medieval Islamic state coexisting with a technologically advanced corporatist state that must think globally to thrive – or, for that matter, to survive. A country of enormous wealth (it sits atop 20 percent of the world's proven oil reserves) the Saudis must nonethe-

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On Saudi Arabia and the Arab Spring

BY ROBERT LOONEY

less cope with an unemployment rate approaching 30 percent. And while the government has spent billions to upgrade the education system, private employers still complain that the lack of a qualified Saudi work force keeps them almost entirely dependent on foreign labor.

The kingdom is cheek by jowl with Syria, Bahrain, Yemen and Oman, countries verging on civil war. Yet, to date, it has barely felt the warm breezes of the Arab Spring; a much publicized "day of rage" last March proved a non-event, with modest local protests that left no visible trace.

That said, a siege mentality seems to be developing – and with good reason. In 2011, the country made the top 10 on *The Economist* magazine's Shoe-Thrower's Index, an informal metric designed to predict the potential for populist regime change in the Arab world. Saudi Arabia did rank behind Yemen, Libya, Egypt, Syria and Iran in readiness for mayhem. But any association with this group can hardly be a comfort to the ruling family. For while the Saudi monarchy has thus far been able to hang on, thanks to its pragmatism and adaptability, past successes don't guarantee future ones.

CRISES: PAST, PRESENT AND FUTURE

Saudi Arabia's response, first to the global financial crisis, then to the Arab Spring, offers evidence of the wiggle room afforded by the country's oil wealth. In the teeth of a sharp fall in oil prices in 2008, the government didn't reduce spending for fear of triggering popular discord. Indeed, it shelled out $160 billion in 2009 – a 26 percent increase over the sum originally budgeted, and more than four times the outlays of a decade earlier. In 2010, spending was increased by another $10 billion (real money in a country of 27 million people), with most of it going toward infrastructure, housing, utilities, health and education.

What's more, worries that the stepped-up spending would produce inflation and current account deficits – or, conversely, would have little impact on aggregate demand – all proved unfounded. In fact, the aggressively countercyclical expenditures enabled the private sector to keep growing at a 3 percent rate right through the international financial crisis.

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The government had planned to ease fiscal stimulus in 2011. But it abruptly reversed course amid concern that the populist virus overtaking autocrats in Tunisia and Egypt (and threatening the one in Bahrain next door) would spread. The king decreed a host of social and economic initiatives, including wage increases and bonuses for state employees, and benefits for the unemployed – the latter being a first for Saudi Arabia. The revised budget also allocated billions of dollars to housing construction and mortgage subsidies. Indeed, the government touched all bases, following up with a very modest bow to giving women the right to vote in local elections, and some tough love in the form of additional support for the dreaded religious police.

But there are limits to what money (and bearded morality enforcers) can accomplish. Little has been done to address yearnings for political liberalization and for an end to pervasive corruption – both of which fueled the uprisings in the Arab states. Perhaps as important, throwing money at discontent may set the stage for more trouble ahead, locking the government into levels of spending that could prove very difficult to sustain in the long run.

PROBLEMS DEFERRED

While the Saudi royal family has handily kept

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the ship of state afloat through the recent turmoil, it will take more than nimble navigation to manage the kingdom's chronic problems.

Unemployment

Among the complaints driving Arab street protests, the one that resonates most in Saudi Arabia is the paucity of jobs. Which raises another irony: generating employment for its own citizens (as opposed to foreign guest workers) has been a priority ever since the oil boom of the 1970s.

In those early years of OPEC muscle-flexing, the government simply expanded its payroll – or that of Aramco, the Saudi oil monopoly – to absorb the growing work force. This make-work option was abandoned in the last decade, thanks to rising concerns over the bloated bureaucracy and the fiscal vulnerabilities associated with cyclical oil markets. As a result, the government turned to the private sector.

Over the past decade, the Saudi native population has grown at an annual rate of 2.5 percent – almost twice the average for emerging economies and four times the rate in the advanced ones. And with half the population now below the age of 23, the government faces the daunting task of getting young people jobs when they finish school.

This demographic bulge is especially worrisome because unemployment in Saudi Arabia is already concentrated among those who recently entered the labor force. According to the official statistics, 39 percent of native workers in the 20-24 age group were unemployed in 2009 – up from 28 percent in 2000. Note, moreover, that the number of new job seekers could rise even more steeply than one might otherwise project if the Arab Spring spurs an increase in female participation in the work force, which, at a mere 12 percent, is among the lowest in the world.

It's clear enough why most women stay home. In 2009, overall unemployment among women was 28 percent, and among those aged 25-29, it topped 45 percent. These numbers are exceptionally striking in light of the fact that 78 percent of unemployed women hold university degrees, compared with only 17 percent of unemployed men.

The employment picture is especially disappointing in light of the fact that the economy has been generating jobs at a brisk clip: private sector employment grew by 674,000 in 2009 alone. But employers are reluctant to hire Saudi citizens, in spite of government financial incentives that offset as much as half of their salaries for the first two years. In part, this reluctance is due to the higher wages they will eventually have to pay. The main obstacle, however, is laws that make it difficult to fire a national – a reality that undermines efforts to get Saudis to do a day's work for a day's pay. As a result, only one private-sector worker in ten is a Saudi citizen.

Various initiatives to increase employment opportunities for Saudis have been dismal failures. But that isn't deterring the government from trying again. A new system of industry-specific quotas was introduced in May 2011. Penalties for noncompliance range from a six-year renewal limit on a company's foreign worker visas to banning visa renewals entirely.

One risk of this initiative is that businesses may simply choose to close down if the combination of low Saudi productivity and high labor costs takes too heavy a toll to the bottom line. Larger firms could easily relocate to the United Arab Emirates, where foreign worker permits are freely issued. There are already more than 2,000 Saudi-owned businesses in Dubai. And since Saudi Arabia imposes no restrictions on capital outflows, others are likely to follow.

Note, moreover, that Riyadh's recent efforts to blunt the impact of the Arab Spring are in conflict with its efforts to expand citizen participation in the private sector: the creation of more patronage jobs in the government and the introduction of unemployment benefits are both disincentives for nationals to seek a living the old-fashioned way. Note, too, that the sort of restructuring of the kingdom's educational curricula required to meet the needs of a growing modern economy won't sit well with the tradition-bound clergy, which favors a religion-based, male-oriented curriculum.

Access to financing represents a further constraint on market activity and job creation. Efforts to make credit available to small- and medium-sized firms through a system of partial loan guarantees are making a difference. However, broader reforms to foster the development of a private market for Islam-friendly credit – yes, this is possible – have yet to materialize.

The Housing Shortage

A vast majority of Saudis can't afford to buy their own houses. Only around 30 percent of Saudis are homeowners, down from 50 percent just two decades ago. The housing supply has simply not kept up with population growth; estimates place the shortfall at two million units. Costs have risen to the point where those young Saudis who do manage to find jobs must continue to live with their parents. The social and political consequences are significant: without homes of their own, they are unable to follow the traditional Muslim path to marriage and family – a frustration shared with Arab Spring protesters in much poorer countries.

tant sources of "investment" by the royals. Cartels of senior princes control large swaths of undeveloped land in major cities, and they keep them off the market to restrict supply and drive up prices. Although King Abdullah has apparently stopped the distribution of state lands to his kin, their accrued holdings are enormous. Some efforts have been made to clean up the most corrupt municipal and judicial organizations that have been giving away land to the highest bidders. However, the cleanup is unlikely to extend to the royals.

Pent-up housing demand has led to Soviet-style queues: the waiting period for a loan has crept up to 18 years! The best guess now is that the latest injection of funds won't even be sufficient to meet the target of reducing the queue to a still-horrendous eight years.

One source of the problem is the property bubble, a not-surprising consequence of the mid-decade oil boom. From 2003 to 2007, the average annual increases in the price of residential land and the price of existing homes in Riyadh were 20 percent and 16 percent respectively. After a lull in 2008-9, housing inflation has started to pick up again. As a result, 70 percent of new housing starts are aimed at the high-end market, affordable to only the top tenth of Saudis. Prices in peripheral regions are considerably lower, but opportunities for employment outside the big cities are few and far between.

Rapid housing price escalation is not entirely the result of the oil-fueled speculative bubble. The division of property ownership between the state and the royal family (which now numbers in the thousands) is blurred. And since the 1980s, the appropriation of state land has become one of the most impor-

After the outbreak of the Arab Spring, King Abdullah did introduce a series of measures to address the housing squeeze. These included plans for the construction of 500,000 new housing units at an estimated cost of $65 billion. That's enough to make a significant difference, but far too little to make the problem go away. And, in any event, access to mortgages remains problematic.

Lower-income Saudis are eligible for subsidies through the government's Real Estate Development Fund, established in the 1970s to distribute zero-interest home loans. The fund dominates the market, accounting for 81 percent of mortgages.

With the rapid rise in housing costs, the fund's mandate has become more pressing, and in February 2011 the king pledged $10.6 billion of additional capital. But pent-up demand has led to Soviet-style queues: the waiting period for a loan has crept up to 18 years!

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Commercial banks, for their part, can't mobilize private capital to finance housing because current laws make it impossible to seize the collateral in case of default. And efforts to correct this contradiction seem doomed to remain on hold as the Majilis al-Shura (consultative assembly) continues to debate its compatibility with Islamic law. Outstanding mortgages currently represent about 2 percent of Saudi GDP, compared with well over 50 percent in most rich countries.

Accelerated housing construction is necessary, but not sufficient, to cure what ails. Even if the supply were drastically increased, significant portions of the native population would remain excluded from the market as long as bank lending is hobbled, unemployment remains high and labor productivity remains low. Indeed, the housing shortage on top of rising youth unemployment could yet become a flashpoint for insurrection – particularly since senior royals are widely understood to have exploited the people's misery to their own advantage.

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Shiites, Rising

In Saudi Arabia's Eastern Province, Shiite unrest presents a far more pressing problem than unemployment or housing. The 10 percent of Saudis who adhere to Shia Islam (as opposed to Sunni) are concentrated there, in close proximity to the country's principal oil fields as well as to strife-torn Bahrain, where Shiites are a majority.

Despite discrimination at the hands of the Sunnis and fierce hostility from the more extreme Wahhabist clerics, a great majority of Shiites are political moderates, holding to the belief that they have more to gain by working with the government than against it. However, many younger Shiites have begun questioning this strategy. And while the "day of rage" hardly stirred Saudi Arabia, it's still significant that a disproportionate number of those who did march were young Shiites.

Demonstrations continue out of sight, in part to protest Saudi intervention in Bahrain. The king has taken steps to smooth the edges of Shiite discontent with – you guessed it –

money. Nevertheless, the risk remains that Shiite anger will spark Iranian-supported terror in the province. The oil fields, which yield hundreds of thousands of barrels daily, along with the infrastructure for maintaining them, will remain juicy strategic targets for decades to come.

Many Shiites pinned their hopes on King Abdullah's 2009 "National Dialogue," which was nominally aimed at normalizing Shia rights. They have, in fact, been allowed a few additional freedoms – for example, the right to hold Shiite festivities in purely Shiite areas like the Eastern Province's main city, Qatif. But changes have generally been limited to the symbolic. There are no Shiite ministers, members of the sect cannot hold jobs in the Ministries of Interior and Foreign Affairs, and Shiite clerics are excluded from the Council of Supreme Ulema (religious scholars).

While King Abdullah and the reformist branch of the al-Saud family are open to greater religious and (to a limited extent) political freedom for the Shiites, the clerical establishment and the Mutawa (religious police) oppose any lessening of the current restrictions. Prince Nayef, half brother of Abdullah and the leading candidate to become crown prince after the death of Sultan bin Abdulaziz Al Saud, echoes their opposition – apparently because he fears that political activism among Shiites could strengthen Iranian influence.

Who's Next?

Prince Nayef's views carry particular import, given the uncertainty that exists because of the age and health of senior members of the Saudi royal family. King Abdullah is 87; Crown Prince Sultan died in October at the age of 83. The 75-year-old Nayef apparently wants the job and seems to be healthy enough to take it on. He has been the formal head of Saudi Arabia's successful counterterrorist program and is reportedly close to senior religious scholars. Moreover, as the best-wired adviser to King Abdullah, he already plays a role in most major decisions.

Saudi kings generally lead by building consensus within the extended family and then among the civil and clerical elites. The most successful have taken clear control in policy matters. Abdullah, for example, has energetically pursued economic reforms and reduced the influence of the most conservative of the Ulema. It is expected that Abdullah's successor will inch further in the same general direction.

However, there is no guarantee that succession will go smoothly. Some of Abdullah's brothers, who are not currently counted among his likely successors, want to accelerate reform, as do many in the next generation of royals. In contrast, Nayef's conservatism and closeness to the hard-line clerics suggest that he will probably approach reform much more cautiously. Such divergent views within the family could result in jostling for the throne and create the potential for regime change.

Where's the Money?

In addition to increased concerns over the ability and inclination of the royal family to manage social and political instability, some analysts argue that business as usual is unsustainable in purely financial terms. While Saudi Arabia is currently enjoying oil revenues in excess of its fiscal needs, government spending and domestic consumption of crude oil are rising far faster than the output needed to cover the cost.

Price caps on domestically used energy (prices are keyed to $10-per-barrel crude), reliance on energy-intensive water desalinization and rapid population growth have all contributed to the surge in domestic energy demand. If this trend toward diverting evermore oil to domestic use continues, sustaining oil exports will require a massive increase in the development of high-cost fields, which Aramco is reluctant to do.

Still, in the absence of major upheavals or wars, the country is likely to be able to live within its considerable means for the next decade. In addition, the Saudi Arabian Monetary Authority, the kingdom's central bank, has reserves roughly equal to three times the government's annual budget. Don't forget, too, that since the country paid off most of its debt during the oil boom years of the 2000s, it has plenty of room to borrow.

This picture could change drastically over the longer term, though, as rapidly expanding domestic consumption cuts into exports around the same time that oil production is expected to level off or even begin to decline. Jadwa Investment, a Saudi financial services provider, estimates that even with a slowdown in escalating government spending, budget deficits may begin around 2014 and become substantial by the 2020s. By 2030, the country's very considerable foreign assets could be exhausted. The fiscal situation could also deteriorate much more quickly if instability continues in countries like Bahrain or spreads to Jordan and Morocco, and the government again responds with spending.

While it is possible that the kingdom will avert a fiscal crisis, doing so would require widely unpopular policy reforms such as selling fuel at home at world prices. To ease internal petroleum energy demand, nuclear and solar energy development is an option – though hardly a cheap one.

Increasing Saudi oil production by more aggressively exploiting reserves may be possible, but it, too, is problematic. Within the OPEC cartel, Saudi Arabia's push to expand production has repeatedly met Iranian resistance. Indeed, there may be pressure on the Saudis to cut production in the future in order to accommodate Iraq. The latter country has the capacity to increase production – and it certainly has the need to finance postwar reconstruction.

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THROUGH A GLASS, DARKLY

Back in 2002, Thomas Friedman of *The New York Times* offered two ways to think about Saudi Arabia's future. In what he called "the Soviet model," Saudi Arabia is viewed as an absolutist state incapable of reforming itself. The kingdom depends on Wahhabi fundamentalism (instead of communism) for legitimacy, and the Saudi religious establishment effectively blocks critical reforms and modernization (just as the Soviet hard-liners once did).

In this model, collapse seems inevitable. Without the reforms to create a dynamic non-oil sector, the combination of a growing population and declining fiscal resources places so much stress on the system that it eventually implodes. Higher oil prices would simply give the kingdom more time to fail.

Friedman's alternative "China model" envisions more flexibility and adaptability. Whereas in China, tensions between communism and capitalism affect the dynamic of change, in Saudi Arabia Wahhabism competes with the forces of modernization. Like China's rulers, the Saudi royal family is sufficiently savvy and pragmatic to do whatever it takes to remain in power, even if it means confronting the religious establishment from time to time in order to press ahead.

Recent developments make this pragmatic "Chinese" path seem more plausible. Last fall, King Abdullah revoked a sentence to lash a woman for driving a car. And he decreed that women could "take part" in municipal elections beginning in 2015. Did that mean they would vote? Run for office? Or maybe just dust the voting booths? The royals and their allies hope that when 2015 rolls around, 91-year-old Abdullah or his successor will be around to decide.